VZCZCXRO9420
RR RUEHAO RUEHCD RUEHGA RUEHGD RUEHHA RUEHHO RUEHMC RUEHNG RUEHNL
RUEHQU RUEHRD RUEHRG RUEHRS RUEHTM RUEHVC
DE RUEHCV #1544/01 2141519
ZNY CCCCC ZZH
R 021519Z AUG 07
FM AMEMBASSY CARACAS
TO RUEHC/SECSTATE WASHDC 9405
INFO RUEHWH/WESTERN HEMISPHERIC AFFAIRS DIPL POSTS
RHEBAAA/DEPT OF ENERGY
RHEHNSC/NSC WASHDC
RUCPDOC/DEPT OF COMMERCE
RUEATRS/DEPT OF TREASURY
RUMIAAA/HQ USSOUTHCOM MIAMI FL

C O N F I D E N T I A L SECTION 01 OF 06 CARACAS 001544

SIPDIS

SENSITIVE
SIPDIS

TREASURY FOR MMALLOY AND KAUSTIN
COMMERCE FOR 4431/MAC/WH/MCAMERON
ENERGY FOR ALOCKWOOD AND CDAY
NSC FOR JCARDENAS
HQ SOUTHCOM ALSO FOR POLAD

E.O. 12958: DECL: 08/02/2017
TAGS: ECON EFIN EPET VE
SUBJECT: A HISTORICAL PERSPECTIVE: NOTHING'S CHANGED,
EVERYTHING'S CHANGED

REF: A. CARACAS 568
¶B. CARACAS 930
¶C. CARACAS 959
¶D. CARACAS 994

Classified By: Economic Counselor Andrew N. Bowen for reason 1.4(d).

SUMMARY

¶1. (C) In analyzing Venezuela's history of boom and bust cycles, a series of patterns emerge that offer predictive value for the end of the current cycle. Links between oil prices, government spending, inflation, and devaluation are clearly evident over the past 35 years as oil booms have led to huge spending increases exceeding the state's revenues. These expenditures produced increases in the money supply and inflation, which along with declining revenues from oil sales, eventually forced the government to devalue, setting off a stagflationary spiral. Oil production has steadily fallen from its 3.8mbd peak in 1970 and production up-ticks have followed large investments (and similarly down-ticks have followed cut backs on investment) normally associated with International Oil Company (IOC) participation in the sector. Given declining production, decreasing investment (especially following recent nationalizations), and massive public spending, it is only a matter of time before Venezuela's history plays itself out once again with devaluation and subsequent stagflation possible within the next two years. END SUMMARY.

FREE MONEY

¶2. (C) Venezuela's GDP growth during the past fifty years has been closely associated with oil income, especially since the early 1970s when oil prices shot up. Venezuelan professor and well-known economist Jose Toro Hardy (PROTECT THROUGHOUT) describes Venezuela's situation from the 1940s until 1983 as one marked by "continual good luck." World crises conspired to drive up oil prices every time the GOV began to endanger its country's fiscal health by profligate spending. World War II, the Shah's nationalization and overthrow, the Suez

crisis, the Six Day's War, the Libyan nationalizations, the Yum Kippur War and oil embargo, and the Iranian Revolution, ensured that oil prices continued on their upward trend, keeping the GOV relatively in the black. From the end of WWII until the oil embargo in 1973, oil prices averaged around USD 2/barrel. In 1971, prices jumped 23 percent. They rose another 22 percent in 1972, 46 percent in 1973, and had grown almost 225 percent by the end of 1974.

FLAPPER GIRLS AND CHAMPAGNE

¶3. (SBU) The major spike in oil prices at the beginning of the 1970s led to massive expenditures under President Carlos Andres Perez. Much of Venezuela's infrastructure dates to the period between 1950 and 1980. Real spending grew by 26 percent annually from 1974 through 1977. Per capita GDP more than doubled during the era (1970-77). Salary growth and the fixed Bs. 4.3/dollar exchange rate led to many Venezuelan shopping trips to the United States, where they coined the phrase, "ta barato, dame dos," or "so cheap, I'll take me two." The accompanying economic growth led to labor shortages and productivity decreases as less-skilled laborers were employed without sufficient training or education. The windfall oil revenues were not sufficient, however, and the government began to take on debt. Public external debt grew from USD 1.2 billion in 1973 to over USD 11 billion by the end of 1978 (in 1978 the Venezuelan oil basket was USD 13.77/barrel, or 617 percent above its price at the start of the decade).

¶4. (SBU) Venezuela's balance of payments experienced a similar decline, falling from a global surplus of USD 3.9

billion in 1974 to a global deficit of USD 5.3 billion in
¶1978. By the end of 1978, the country's foreign debt exceeded its international reserves, although reserves had grown almost 400 percent during this period. Government expenditures resulted in large liquidity increases, which pushed inflation from an average of 1.6 percent during the period between 1960 and 1972 to a high of over 10 percent in the year 1975.

-- -------------
JUMPING OUT OF SKYSCRAPERS, HAD THEY BOTHERED TO BUILD ANY
-- -------------

¶5. (C) Venezuela was saved from a balance of payments crisis by the increasing price of oil after the fall of the Shah of Iran in 1979. Oil prices for Venezuelan crude grew to a new high of USD 38.21 in 1981 (an 1800 percent increase over a decade earlier). At the same time, the Venezuelan economy was showing signs of trouble marked by huge budget and current account deficits, which Toro Hardy attributed to: a rigid system of price controls, state subsidies, and massive importation (all of which will sound familiar to present day Venezuela watchers). By 1983, public external debt had grown to over USD 27 billion, more than double the country's USD 12 billion in foreign exchange reserves. On February 18, 1983, "Black Friday," Venezuela instituted currency controls and partially devalued the currency from Bs. 4.3/dollar to a dual rate of Bs. 4.3/dollar for preferential items and Bs. 6/dollar for other items. This was the first significant devaluation in Venezuela's modern history. Among other effects according to Toro Hardy, the Differential Exchange System Office, or RECADI, setup in 1983 "transformed itself into one of the largest sources of corruption ever known in the history of Venezuela."

¶6. (SBU) The 1983 devaluation was followed by others, such that the bolviar today has fallen to Bs. 2150/dollar at the official exchange rate, Bs. 4200/dollar as of August 1 at the parallel exchange rate. In his 2005 article "El Capitalismo Rentistico," economics professor Asdrubal Baptista charts

productivity and real salaries over a period from 1950 to
¶2002. Productivity had grown by as much as 70 percent from 1950 to 1978, before steadily falling below 1950 levels by
¶2002. Real salaries per capita grew over 350 percent by the end of the 1970s, only to have fallen back to 1950 levels in
¶2002.

¶7. (SBU) Venezuela experienced another boom in the late 1980s under President Jaime Lusinchi, despite relatively low oil prices and stagnant production. This boom, driven by massive deficit spending, failed to jump-start the economy. The government's policy of devaluation (from Bs. 7.5/dollar to Bs. 39.3/dollar at the end of 1988) made it possible to increase spending (in bolivar terms) throughout this period, though rising liquidity (almost doubling between 1985 and 1989) and inflation resulted in an economic crisis in 1989. Having continually postponed austerity measures under Lusinchi and then Carlos Andres Perez, when the government of Carlos Andres Perez eventually did accept IMF policy prescriptions, the measures were harsh and poorly understood by the population. The direct result of this crisis was the "Caracazo," a period of massive civil unrest which resulted in hundreds (if not thousands) of deaths before the military restored order.

--- --
FEWER DRILLS, MEANS FEWER HOLES, MEANS LESS OIL
--- --

¶8. (C) While oil prices have by and large had the most important effect on the Venezuelan economy during the past half century, oil revenues are equal to price multiplied by production. Despite some upticks related to IOC investment in the 1990s, Venezuelan oil production has trended downward since 1970, when it peaked at 3.8 million barrels/day (mbd). Contrary to government claims, most experts estimate Venezuela's current crude production to be approximately 2.4mbd. Oil production is closely related to investment in the sector, which for the majority of Venezuela's modern

history has been provided by international oil companies (IOCs). In a recent presentation to Econoffs, the investment firm Sequoian (PROTECT THROUGHOUT) charted oil investment and production levels over the past 50 years. During "open" periods, IOCs invested heavily in Venezuela, and investment preceded increases in production by a couple of years. When the government clamped down on foreign investment, or nationalized the sector (as it did in 1976), IOC participation dropped, as did subsequent production levels.

¶9. (SBU) Rig counts serve as a proxy for measuring the country's ability to maintain and increase production. The number of working rigs in Venezuela rose from 30 in 1990 to a high of 120 at the end of 1997 (during the "apertura petrolera," or oil opening that the GOV instituted in the 1990s to attract foreign investment during a period of oil prices below USD 20/barrel). In 1997 oil production also peaked at 3.5mbd. The campaign and election of Chavez in 1998 scared off investment, and rig counts fell to 58 at the beginning of 1999, when Chavez took office. As of June 2007, Baker Hughes estimates that there are 82 working rigs in the country, well below the number needed to achieve the BRV's claimed production of 3.1mbd.

¶10. (SBU) The Central Bank calculates the oil sector as a percentage of GDP at constant 1997 prices, reflecting mostly changes in production and investment, rather than changes in the price of oil. The price of the Venezuelan oil basket has grown from USD 10.60/barrel in 1998 to USD 67.72/barrel as of the week ending July 13 (a 539 percent increase). Yet, according to the Central Bank, the oil sector as a percentage of GDP has essentially not changed since 1997 (remaining below 10 percent), demonstrating a lack of investment or production increases, even during recent years of historically high oil prices.

MONEY SUPPLYING THE EXCHANGE RATE

¶11. (SBU) Since the Bs. 4.3/dollar exchange rate was broken in 1983, Venezuela's currency has steadily devalued to Bs. 2150/dollar where it is set officially today. The implementation of exchange controls in February 2003 made managing the exchange rate more important as the Finance Ministry tried to balance the government's needs for spending with foreign exchange reserves and inflation expectations. During the 2003-2005 period under Finance Minister Nobrega, Venezuela steadily devalued every year, always devaluing the currency such that the new rate was higher than the implicit rate obtained by dividing the money supply (M2) by foreign exchange reserves. By keeping the official rate above the implicit rate, the BRV reduced capital flight and protected its reserves.

¶12. (SBU) Venezuela last devalued its currency in March 2005. Since then, the money supply has grown by 141.8 percent and accumulated official inflation has been 39.5 percent. FX reserves covered 140 percent of monetary liquidity in 2004 and only 46 percent as of the end of July 2007. This has changed the implicit value of the currency from Bs. 1895/dollar in March 2005 to Bs. 4676/dollar as of the end of July 2007. If one includes outstanding certificates of deposit (CDs) issued by the Central Bank (BCV) to banks to reduce monetary liquidity, the implicit rate grows to Bs. 6644/dollar. As of August 1 the unregulated parallel market rate was Bs. 4400/dollar.

RUNNING OUT OF STEAM?

¶13. (SBU) At the same time that oil prices have remained relatively high but with production falling, the government is implementing new policies that will affect its bottom line. On July 1, Venezuela reduced the Value Added Tax (IVA) rate to 9 percent, down from 14 percent at the beginning of the year and exonerated a number of agricultural and food items from the tax. The economic newsletter Analisis

Venezuela estimates that the reduction will cost the government as much as USD 6 billion (at the official Bs. 2150/dollar exchange rate) over the course of the year. This amount represents over 45 percent of the IVA take estimated in the 2007 budget. The reduction in tax revenues places additional burden on oil exports to fund the Venezuelan state as in 2006 income from IVA represented almost 47 percent of total (non-oil) tax revenues. Government revenues are divided almost evenly between non-oil and oil income.

¶14. (SBU) Recent nationalizations have placed additional burdens on the state. In taking over the heavy oil strategic associations, PDVSA has effectively increased its required capital contributions to the new joint ventures. National telecom provider CANTV recently announced that it would need a USD 150 million subsidy from the state in 2007. In 2006, CANTV paid out USD 340 million in dividends to its private shareholders.

¶15. (C) According to IESA Professor Gustavo Garcia (PROTECT THROUGHOUT), the first quarter 2007 balance of payments data released by the BCV paints a troubling picture (reftel C). The 48 percent decline in the current account from Q1 2006 is due to decreased oil revenue and increased import consumption, which imply that Venezuela could begin running a current account deficit in the near future. Such a deficit, in Garcia's estimation, would necessitate a devaluation once foreign exchange needs exceed foreign exchange income as was the case in 1983. Given the continuing rise in imports (up 47 percent in Q1 2007 as compared to Q1 2006), stagnating or

falling income from oil sales, and a current account inflated by calculations based on PDVSA's fictitious production numbers, this deficit could occur sooner rather than later, in Garcia's estimation by the second half of 2007 or early ¶2008.

¶16. (C) At the same time, record-high government spending continues. When off-budget spending by FONDEN, PDVSA, and other state-owned enterprises is estimated, public sector spending now approaches 40 percent of GDP. This level spending is clearly unsustainable, and the BRV and PDVSA have been taking on debt to cover current expenditures (reftel B). According to banking sector contacts, PDVSA drew down its USD 1 billion revolving credit facility arranged by BNP Paribas in January in a week, and its USD 3.5 billion loan from JBIC in less than two weeks. While the BRV has maintained spending levels for the first half of 2007 at end of 2006 levels (rather than increasing them 20 percent year on year, as has been the average increase during the past eight years), increasing inefficiency and corruption are taking their toll on spending efficacy. Moreover, Chavez will surely prime the fiscal pump later this year as he unveils constitutional reforms and other fundamental changes to the Venezuelan state.

DEVALUE THIS

¶17. (SBU) Both Chavez and Minister of Finance Cabezas have repeatedly denied plans to devalue the bolivar. Despite their persistent denials, most analysts expect a devaluation in 2008 or early 2009 as the BRV needs more bolivars to fund spending and pressures on foreign exchange reserves force its hand. For some, the easiest method to devalue is via the monetary conversion planned for January 1, 2008 (reftel A). The BRV insists that there will be no change in valuation, only in denomination (removing three zeroes, so that a new "bolivar fuerte" is valued at BsF. 2.15/dollar). Should the BRV not take advantage of the conversion to devalue, it will nonetheless have to do so at some point due to increasing costs, decreasing revenues, and decreasing foreign exchange reserves caused by a negative balance of payments.

¶18. (SBU) A devaluation would hit the Venezuelan economy hard as Venezuela's reliance on trade (exporting oil and importing goods) has effectively resulted in a dollarized economy. Inflation would shoot up as producers and retailers adjust their prices based on the new exchange rate, and individual

Venezuelans see their savings eroding. The hollowed out domestic industrial base would mean that local producers could not increase supply to make up for the decrease in imports as Venezuelans' purchasing power abroad diminishes. Oil exports today represent around 90 percent of Venezuela's foreign exchange earnings, up from 70 percent in 1998.

¶19. (SBU) The monetary conversion law makes it illegal to round up or raise prices as part of the monetary conversion. A packaged devaluation with price freezes could make it very difficult for businesses to stay open, pushing most commerce into the black market. Some local analysts suspect that the BRV may institute economy-wide price controls in advance of the October 1 requirement to express prices in both "old" and "new" bolivars, as after that date an illegal price increase would be too obvious. Given the general expectation of a future price freeze, most businessmen polled by econoff plan to raise prices in advance of the October deadline, resulting in large price spikes in August and September, just as Venezuelans come back from vacation and go back to work and school.

¶20. (C) Section contacts almost universally agree that the BRV will have to devalue within the next 6-18 months, though there tends to be two schools of thought as to the amount by

which they will devalue. Some expect a 10-20 percent devaluation as has been the case in recent years, whereas others argue only a massive devaluation (by as much as 100 percent) would be sufficient to bring the economic indicators back into alignment. A devaluation to 4.3 BsF./ dollar tied up in the monetary conversion would have the historical significance of returning the nominal exchange rate to the rate seen during Venezuela's glory days of the 1970s. Of course, in reality it would represent a 1000 percent fall in the bolivar's value vis a vis the dollar during the past three decades and kick off an inflationary wave.

I GET KNOCKED DOWN, BUT I GET UP AGAIN

¶21. (C) Toro Hardy is quick to point out that while the causes of the next economic crisis may be similar to previous crises, the government's ability to manage a crisis is very questionable. In a recent issue of Veneconomy, its editor Robert Bottome notes that, as opposed to 1989, today the private sector is effectively hollowed out and lacks the capacity to survive a downturn, let alone ramp up production to meet domestic need as imports become prohibitively expensive after devaluation. In addition, it seems unlikely that Chavez would be willing to take "orthodox" steps to re-balance the economy in a crisis. In 1989, the IMF bailed out Venezuela and the government imposed a series of structural adjustments--the bogeymen of many of Chavez' attacks. Institutions such as the Central Bank, Fogade (the Venezuelan FDIC), and Sudeban (the banking regulator) are no longer autonomous (the BCV may lose its dejure autonomy during constitutional reforms currently planned) and Econ contacts have become increasingly skeptical of the capacity of these entities to deal with a crisis in a calm or competent manner.

COMMENT

¶22. (C) Devaluation has become unfortunately common in Venezuela's recent history, however it would nonetheless be a bitter pill for Venezuelans to swallow. Coupled with retrograde policies such as a general price freeze, a devaluation could severely disrupt the distribution/supply chain, already strained by rolling shortages (reftel D). Conventional wisdom dictates that inflation and devaluation hurt the poor the most, though the pervasiveness of both in Venezuelan history make it hard to judge how Chavez' (mostly poor) supporters would react. As recently as 1996 inflation exceeded 100 percent. It is likely that he would lay the blame on someone else, and could use such an opportunity to take over productive sectors accused of raising prices or

hoarding goods that would be sold at a loss, further destroying the country's productive capacity.

¶23. (C) Since 1957, the Venezuelan economy has grown on average at 0.4 percent per year. This dismal picture is in part a result of the series of oil-fueled booms and busts that have tended to leave Venezuelans worse off than when they started. During that time period, the population grew from 6.6 million to 27 million today. At the same time, historically Venezuela has been able to increase oil production when prices fell (often cheating on its OPEC quota). This ability does not exist today. The foolishness of the 1970s and 80s, including growing expenditures faster than revenues, taking on additional debt, increasing state economic intervention, and under-investment in all economic sectors took its toll for two decades. The disillusionment of many Venezuelans with the "punto fijo" system (which refers to the political system between the end of dictatorship and Chavez' rise to power, governed by a supposed 1958 agreement between Venezuela's political parties

to share power) stems from their memories of the 1970s and disappointment of all that followed (around 75 percent of Venezuela's population was born after 1970).

¶24. (C) The virtual unanimity among economists that Venezuela will eventually have to devalue combined with the variety of opinions as to when this will occur illustrate the amount of maneuvering room still available to Chavez. A devaluation will hurt most Venezuelans by decreasing the value of their savings and increasing the costs of goods and services, and it will be very unpopular and lead to rapid inflation. Whether devaluation is the result or cause of an economic correction depends on other factors, including the price of oil, the balance of payments, foreign exchange reserves, and how long the government postpones the decision to devalue. At some point, as has been the case during much of Venezuela's recent history, it will be unavoidable. END COMMENT.

FRENCH